

**Questions and Answers on Renewal Community (RC) and
Empowerment Zone (EZ) tax incentives
Updated February 2003**

The first 30 questions below pertain to Renewal Community and Empowerment Zone tax incentives. The second set of 20 questions pertains to the Commercial Revitalization Deduction (CRD), an incentive available only to Renewal Communities.

- 1) Can a business benefiting from Renewal Community tax credits transfer those credits to another business entity, i.e., a flow-through entity?

Answer: No. There is no provision in the Internal Revenue Code (IRC) that allows one entity to transfer an unused Renewal Community employment credit to another entity.

- 2) With respect to the employment tax credit, can an employer count the time an employee is on a tour boat in, for example, Lake Champlain that starts and stops its tours in the Renewal Community?

Answer: To qualify for the credit, substantially all of the services performed by the employee for the employer must be performed within the Renewal Community. Any services that are performed outside of the Renewal Community's geographic boundaries would not count under this test.

- 3) Can real estate professionals qualify as Renewal Community businesses?

Answer: Yes, provided the property owned by the real estate professional is not residential rental property and at least 50% of the gross rental income from the lessees is from Renewal Community businesses. Note that property is residential rental property only if at least 80% of the gross rental income from the property is from dwelling units.

- 4) Can a bank, located in an RC with more than 35% of its employees being in the RC and doing more than 50% of its business in the RC, meet the definition of an RC business? This question arises since the provision stating that less than 5% of the aggregate adjusted bases of the property of the business be attributable to "non qualified financial property" is unclear. What type of business is this provision referring to?

Answer: No, unless less than 5% of the bank's average aggregate unadjusted bases are attributable to nonqualified financial property. Nonqualified financial property includes debt and other similar property (other than accounts or notes receivable from sales or services). There is no explanation in the Congressional Committee Reports as to the types of businesses targeted by this provision.

- 5) A company is located in an Empowerment Zone and leases employees from a third party employer (which is located outside the EZ). The company pays the third party employer a fee that includes gross wages, payroll taxes and administrative fees. These leased employees are residents of the EZ and work 100% of their available time at the company. Who can take advantage of the EZ Employment Credit - the company or the third party employer?

Answer: Only the employer for Federal employment tax purposes is eligible for the credit. See IRS Publication 15-A for more information on the treatment of leased employees for employment tax purposes.

- 6) Since the Indian Employment Credit is larger than the RC Employment Credit, should the Tax Code be amended to allow the employer to receive both?

Answer: The Indian employment credit and the work opportunity tax credit are coordinated to prevent overlap. This is also true for the Renewal Community employment credit and the work opportunity tax credit. However, because the Indian employment credit and the Renewal Community employment credit are not so coordinated, an employer may claim both of these credits with respect to the same wages. The failure to coordinate these two credits may have been a legislative oversight. Therefore, the enactment of a technical correction to prevent an overlap of these credits is a possibility.

- 7) Can an employer receive the RC Employment Credit for an employee who lives in one RC and works in another, or lives in an RC and works in an EZ, or vice versa?

Answer: No. Wages must be paid to a qualified zone employee to qualify for the credit. To be a "qualified zone employee," the employee must live in the same Empowerment Zone or Renewal Community in which substantially all of the services are performed for the employer. (IRC section 1396(d)(1)).

- 8) To qualify as an EZ or RC business, based on the percentage requirements, can investments and employees be in multiple designated RCs or EZs?

Answer: Yes, except that the tests for Empowerment Zones and Renewal Communities must be figured separately (i.e., you can aggregate RCs with other RCs, but not with Empowerment Zones, and vice versa). (IRC sections 1397C and 1400G).

- 9) In what manner can national or international conglomerates participate in this program if they have a plant or plants located in the RC?

Answer: To qualify as a Renewal Community business, a large business can set up a separate legal entity (e.g., a subsidiary or partnership). Activities of legally separate (even if related) parties are not aggregated for purposes of determining whether an entity qualifies as an Enterprise Zone [or Renewal Community] business. (P.L. 103-66, House Committee Report).

10) With respect to EZ or RC Employment Credits, is the 90-day period calculated based on the calendar, or on days worked?

Answer: The 90-day test is based on calendar days, not days worked.

11) Do you count family members as employees in determining if the business is considered a Renewal Community Business? For example, if a business located in the Renewal Community has ten employees, four of whom are family members who live in the RC, how many employees need to live in the RC in order to be considered a Renewal Community Business? Would it be 35% of 10 employees or 35% of 6 employees?

Answer: Yes, employees who are also family members count for purposes of the 35% test. So, in the example, you would base the test on 10 employees.

If the answer is a fraction, do you round up or down to determine the correct number of employees?

Answer: You would not round at all. At least 35% of the employees must be residents of a Renewal Community. For any percentage less than 35%, the employer would fall below the 35% threshold and would fail to meet the test.

12) Are tips considered Qualified Wages in order to determine the Renewal Community Employment Credit?

Answer: No. Wages are defined in IRC section 1397 by reference to IRC section 51, which in turn defines them by reference to IRC section 3306(b). Because tips are counted as wages under IRC section 3306(s), not IRC section 3306(b), tips do not count as wages for figuring the Renewal Community employment credit.

13) The 0% capital gains benefit is available to "Renewal Community businesses". What happens if, during the 5-year period that the asset must be held, the status of the business changes? For example, a business buys a building 1/1/2002 and meets the RC Business definition during 2002, 2003, 2004, but doesn't meet the definition in 2005 and 2006. The business sells the property in 2007 after holding it five years. Does the business still get the 0% capital gains tax rate on the profits?

Answer: No. To qualify for the capital gain exclusion, substantially all of the use of the property during substantially all of the taxpayer's holding period must have been in a Renewal Community business. Although "substantially all" is not defined in the Code for this purpose, it seems clear that qualifying as an RC business for only 3 of 5 years would not be considered "substantially all" of the taxpayer's holding period.

What about a scenario where the business meets the criteria for a Renewal Community business in 2002 and '03, doesn't meet it in '04, but regains the status for '05 and '06, and sell in '07 while it still meets the criteria. Does the business get the 0% capital gains tax rate on the profits?

Answer: To qualify for the capital gain exclusion, substantially all of the use of the property during substantially all of the taxpayer's holding period must have been in a Renewal Community business. Because "substantially all" is not defined in the Code for this purpose, it is unclear if qualifying as an RC business in 4 of 5 years would be considered "substantially all" of the taxpayer's holding period.

- 14) Based on the 1990 Census Tract data, one major employer's address is located in the RC. The firm has several adjacent buildings connected by pedestrian walkways that are physically located outside the RC, simply by the demarcation lines of the census tract. If all the connected buildings have one central address, however, that is located in the RC, can all the buildings be considered to be inside the RC?

Answer: Under IRC section 1397C(f), if a business uses real property located both within and outside an RC, and the amount of the real property located within the RC is "substantial" when compared to amount of the real property located outside the RC and contiguous to the real property within the RC, the contiguous property is treated as being within the RC. However, this rule applies only for purposes of defining a "Renewal Community business." For any other purpose, the taxpayer can get an answer by submitting a private letter ruling request to the IRS.

- 15) If the tax year for a business is other than the calendar year, when would the business claim the Renewal Community/Empowerment Zone wage credits? For example, if the business's fiscal year runs from October 1, 2001 through September 30, 2002, should it claim all credits earned during this period when it files its 2002 tax return or should it claim the October - December 2001 credits in its 2001 tax return and then claim the January - September 2002 credits in its 2002 tax return?

Answer: The credit is based on the qualified wages paid or incurred during the CALENDAR YEAR that ENDS DURING the taxpayer's FISCAL YEAR.

EXAMPLE: For a taxpayer with a fiscal year ending on September 30, the credit for CALENDAR YEAR 2002 wages is claimed on Form 8844 for the FISCAL YEAR that begins October 1, 2002 and ends on September 30, 2003. That's because December 31, 2002 falls within the fiscal year ending September 30, 2003.

Therefore, for the wages paid or incurred from January 1 - December 31, 2001 (Renewal Community/Empowerment Zone employment credit only), the credit would be claimed on the return for the fiscal year that begins on October 1, 2001, and ends on September 30, 2002. For the wages paid or incurred from January 1 - December 31, 2002, the credit would be claimed on the return for the fiscal year that begins on October 1, 2002, and ends on September 30, 2003. Therefore, even though the taxpayer's DEDUCTION is for fiscal year wages, the CREDIT is for calendar year wages.

NOTE: This rule applies ONLY to the Empowerment Zone and Renewal Community employment credit. The work opportunity credit, welfare-to-work credit, and Indian employment credit all use FISCAL YEAR wages.

- 16) In an Empowerment Zone of less than or equal to 100,000 people, is the total allocation of EZ facility bonds \$130 million?

Answer: For Urban EZs, the allocation for the EZ over the period of designation is \$130 million if the population of the EZ (not the population of the city or county) is less than 100,000 people. If the EZ population is 100,000 or more, the allocation is \$230 million. There are no per-borrower limits.

For rural EZs, regardless of population, the allocation is \$60 million.

- 17) Can a building construction site in a Renewal Community qualify for Renewal Community employment credits?

Answer: The RC employment credit is available for any employee that performs substantially all of its services during the period in the RC and also lives in the RC. The IRS has interpreted the language “the period” to include pay periods. So if an employee is working at a construction site for substantially all of specified pay periods, the wages paid during those pay periods would be qualified wages eligible for the 15% credit up to \$10,000 per year in wages. The employee must live in the RC that same time period.

- 18) To qualify for the zero-percent capital gains rate, what percentage of a business’s gross income must come from the active conduct of business within the Renewal Community, is it 50% or 80%?

Answer: The 80% rule is an Enterprise Zone benefit that applies only to businesses operating in the District of Columbia. For Renewal Community businesses, at least 50% of gross income must come from the active conduct of business within the RC. That does not mean that the customers or products of the business must come from the RC; it means that the business must perform its business in the RC. For the purposes of determining what is gross income, this income would be the same figure that a business would use for other federal tax purposes.

- 19) Are the employers and employees that use the Renewal Community and Empowerment Zone tax incentives required to be residents of the United States?

Answer: For purposes of figuring the RC and EZ credits and deductions, neither the owner nor the employees are required to be U.S. citizens.

- 20) When will the IRS tax forms be ready for Renewal Communities that use the available tax incentives?

Answer: The IRS is developing these forms and plans to release them in the fall of 2002. Drafts (subject to change) of the 2002 forms are available for viewing on the Internet at: http://www.irs.gov/bus_info/tax_pro/dftform2.html

- 21) With regard to the Renewal Community or Empowerment Zone employment credits, what does "substantially all" mean in regards to services performed? How does a company determine if an employee meets this test?

Answer: Although there is no published guidance on this question that specifically relates to the renewal community employment credit, the IRS recently ruled that "substantially all" means "80% or more" as it relates to identical statutory language regarding services performed by New York Liberty Zone business employees for purposes of the work opportunity credit. So, in the absence of any other guidance, it would not be unreasonable to apply that same percentage for purposes of the RC employment credit.

- 22) Could a tax-exempt organization take advantage of the RC or EZ employment credits?

Answer: "Tax-exempt organizations (other than farmers' cooperatives) are not eligible to claim the RC employment credit."

- 23) What if a sister of the employer works at a company that wishes to use the RC or EZ employment credits – if she is married and files her taxes separately from the employer, will she qualify under the employment credit rules?

Answer: No. Under IRC section 152(a)(3), wages paid to brothers, sisters, stepbrothers, and stepsisters of the taxpayer are not qualifying wages for purposes of the empowerment zone employment credit or the renewal community employment credit. Other subsections of section 152 prohibit the credit for any wages paid to sons, daughters, stepsons, stepdaughters, a father or mother (or an ancestor of either), a stepfather or stepmother, aunts, uncles, nieces, nephews, and various in-laws.

- 24) What tax form should EZ businesses use at this point to itemize rolled-over gains on the sale of EZ assets that are purchased after December 21, 2000, held for more than 1 year, and then replaced within 60 days?

Answer: Schedule D or Form 4797 is used (i.e., the same form that would normally be used in the absence of a rollover). The instructions for reporting the rollover of gain on the sale of EZ assets for Schedule D filers are on page 60 of Pub. 550.

- 25) The RC/EZ wage credits indicate the employee must live in the EZ/RC. How, then, would an RC or EZ use these credits when providing employment for a homeless individual?

Answer: There seems to be no definition in the IRS Code, committee reports, or other published IRS guidance defining "principal place of abode" of the employee, which must be located in the EZ/RC. The employer is responsible for proving that the employee's principal place of abode was within the zone during the period the services were performed for the employer. Presumably, this is the address that the employee would have entered on Form W-4 upon starting work. There seems to be no reason why a

homeless shelter could not be considered a "principal place of abode." This is a compliance matter and would only be raised (if at all) during an audit of the employer's tax return.

- 26) The rules on the Work Opportunity Tax Credit (WOTC) mention many groups from which prospective employees must come (ex-felons, veterans, recipient of TANF funds, etc.) but don't mention homeless. Would an employer qualify for WOTC simply because an employee is homeless, or must the homeless person also meet one of the other conditions?

Answer: An employer cannot claim the WOTC for wages paid to a homeless individual just because he or she is homeless. The individual **MUST** be a member of a targeted group for the employer to qualify for the WOTC.

Questions added February 11, 2003:

- 27) I sent an earlier question to you concerning whether or not an employer can claim the wage credits on employees who receive a 1099 at the end of the year. I have looked at the Tax Guide for Business and see that qualified wages have to be subject to the FUTA. If the employer pays unemployment tax, they are qualified to claim the credits on a 1099 employee, correct? Or am I wrong?

Answer: No. An employee doesn't receive a 1099. 1099's are to report amounts paid to contractors, not employees. If all people performing services for the company are getting 1099s, then the company isn't even an employer. The wages must be subject to FUTA, not have FUTA voluntarily paid on them. Wages subject to FUTA are wages to employees, and are also subject to FICA. The amounts paid must be wages paid to employees and be subject to (legally, not voluntarily) both FICA and FUTA. The definition uses FUTA only because that is generally the standard used to determine whether wages are subject to other things, including FICA.

- 28) I see that "certain cooperatives" may qualify to use Renewal Community and Empowerment Zone employment credits? What cooperatives would these be? Are telephone and electrical cooperatives included?

Answer: No. The cooperative must be a cooperative described in section 521, farmer's cooperatives.

- 29) In defining non-qualifying zone employees in its discussion on the employment credits, IRS Publication 954 refers to employees of a farming trade or business. What is the definition here of "farming"? Does this include those employed in horse farming, cattle farming, tobacco farming, goat producer cooperatives, etc?

Answer: Yes. Farming is defined in section 2032A(e)(5)(A) and (B) as:

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including animals) on a farm, and

(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its un-manufactured state, but only if the farmer regularly produces more than one-half of the commodity so treated.

The one-half requirement generally is not met by farmer's cooperatives, hence they are generally eligible for the credit.

However, small farms are eligible. Small farms are those whose business assets (greater of unadjusted basis or fair market value) plus the value of leased business assets does not exceed \$500,000. Tree farms are also eligible.

30) What documentation is required if employer wants to claim the RC wage credit? If the business have employee records showing residence during employment is this sufficient?

Answer: There's no pre screening for the RC wage credit. The taxpayer files would need a signed statement by the employee attesting to residence, which is usually found in the employment application. At some point, the taxpayer would have to determine if the residence is in the zone, but this would only be checked by the IRS during an audit. Most use the HUD address locator available from our website at www.hud.gov/cr. There are also consulting firms who verify addresses.

The remaining questions and answers pertain to the Renewal Community Commercial Revitalization Deduction (CRD):

- 1) Can the CRD apply to construction that started before January 1, 2002?

Answer: Yes, provided an allocation was made to the building not later than December 31 of the calendar year the building was placed in service.

- 2) If a State finishes appointing a Community Revitalization Agency and receiving public approval of the CRD allocation plan during the 2nd half of a calendar year, can it still make CRD allocations available retroactively to a business that purchased or rehabilitated qualified Renewal Community (RC) property earlier in the year?

Answer: Yes.

- 3) Are CRD allocations made only after projects are placed into service so that actual costs are used, or are allocations based on estimated costs? If proposed projects are used, how will any discrepancies between actual qualifying expenses versus estimated qualifying expenses be reconciled?

Answer: The statute does not require allocations to be based on either actual or estimated costs. All allocations must be made pursuant to a qualified allocation plan approved by the governmental unit of which the agency is a part. The governmental unit may approve the plan only after a public hearing has been held following reasonable public notice.

- 4) If the commercial revitalization agency for the state allocates, for example, \$8M of an available \$12M to one project, does the entire \$8M count against the total available allocation of \$12M for that year, regardless of the deduction method used by the business (50% in 1st year or 10% over 10 years)? Also, would the amount of allocation for the RC the next year be impacted by the amount and deduction method (i.e. 50%, 10%) used by the business in the RC the previous year?

Answer: The entire \$8 million counts against the \$12 million available allocation. The amount or method chosen by the business to claim the CRD has no effect on the amount of the allocation for any year.

- 5) The CRD states that a company can exercise one of two options for taking accelerated deductions, (1) a 50% write off, or (2) a 100% write off of "all of its investment over a 10 year period". Is the stipulation under (2) limited to the \$10.0 million per project cap, or if a company had an expense of, for example, \$38 million, could it write off (depreciate) this entire amount over a 10-year period?

Answer: No. Under either method, the company cannot take accelerated deductions in excess of the expenditure amount allocated to the building by the CRA (or \$10 million, if less). The remaining expenditures must be capitalized and depreciated under the applicable MACRS recovery period (generally 39 years).

- 6) If an RC is not able to award the total of 12 million in any given year, is there a carry forward provision to the next year?

Answer: No.

- 7) Is the depreciation in the CRD based on straight-line accounting?

Answer: Yes. The deduction is allowed ratably over a 120-month period.

- 8) Can a business in the RC take both the CRD and the general credits available for the rehabilitation of historic buildings?

Answer: Yes. However, the expenditures used to figure the rehabilitation credit may not also be used to figure the CRD. (IRC section 1400I(b)(2)(B)(ii)).

- 9) How does the CRD apply to mixed-use buildings? What is the amount of residential space that is allowed? Are there any other limits on the mix of uses?

Answer: The CRD applies to any nonresidential real property. Nonresidential real property is any real property other than (a) residential rental property or (b) property with a class life of less than 27.5 years. Residential rental property is a building or structure for which at least 80% of the gross rental income is rental income from dwelling units. Therefore, if less than 80% of a building's gross rental income is rental income from dwelling units, the building would qualify for the CRD.

- 10) Part of the qualified allocation plan requires the RC to have a monitoring piece in place. What level of monitoring will be required by the state commercial revitalization agency?

Answer: The qualified allocation plan is required to provide the procedures that the agency will use in monitoring compliance. There is no statutorily-mandated "level" of monitoring.

11) What forms are required to claim the Commercial Revitalization Deduction?

Answer:

- If the 50% deduction is claimed, it will be claimed under “other deductions” or “other expenses” on the taxpayer’s income tax return or business schedule (e.g., Schedule C).
- If amortization over a 120-month period is claimed, the deduction is claimed on line 42 of Form 4562 (for the first tax year) and also on the “other deductions” or “other expenses” line of the taxpayer’s income tax return or business schedule.
- For partners and S corporation shareholders, the deduction will be included in the net income or loss claimed in Part II of Schedule E (Form 1040).
- Form 8582 must also be used to claim the special \$25,000 allowance if the CRD is from a passive rental real estate activity. The \$25,000 allowance for the CRD applies to all taxpayers regardless of their AGI.

12) If a business has a net operating loss as a result of using this deduction, is it treated in the same manner as a net operating loss under the current tax code?

Answer: Yes.

13) Does the tax code require RC states to adopt the CRD (and other RC incentives) for state tax purposes -- so that when a business determines their federal taxable basis with use of RC deductions - that taxable basis is carried over to the state tax return? (This doesn't pertain to the state process for allocating credits - rather a state's recognition of federal tax incentives for the state's taxable basis.)

Answer: No. No provision of the Internal Revenue Code requires any state to follow Federal income tax law for state purposes.

14) What factors should a state consider in determining the recipients of the CRD and the amount per recipient?

Answer: The qualified allocation plan must set forth such criteria that are appropriate to local conditions. Specifically, the plan must consider:

- The degree to which a project contributes to the implementation of a strategic plan that is devised for a Renewal Community through a citizen participation process,
- The amount of any increase in permanent, full-time employment by reason of any project, and
- The active involvement of residents and nonprofit groups within the Renewal Community.

15) For an RC on an Indian Reservation, does the tribe act as the State in allocating the CRD?

Answer: The reservation governing body (as determined by the Secretary of the Interior) is treated as being both the state and local governments with respect to the Renewal Community. (IRC section 1400E(a)(5)).

16) What is the earliest date by which a CRD allocation can be made?

Answer: The CRD allocation can be made at any time, starting in 2002, provided it is made under a qualified allocation plan that has been approved by the governmental unit of which the Commercial Revitalization Agency (CRA) is a part. The CRA must also notify the CEO of the local jurisdiction in which the building is located of the allocation and give that individual a reasonable opportunity to comment on the allocation.

If the allocation is made in calendar year 2002, IRC section 42(h)(1) requires that:

(a) The building is placed in service by December 31, 2002, OR

(b) The building is placed in service no later than December 31, 2004, AND the taxpayer's basis in the project in which the building is a part (as of 6 months after the date the allocation was made or, if later, December 31, 2002) is at least 10% of the taxpayer's reasonably expected basis in the project (as of the end of 2004).

However, if it is determined that the building may not meet either deadline, IRC section 42(h)(1)(C) allows the CRA to make a "binding commitment" to allocate a specified dollar amount to the building in a specified later tax year. The binding commitment must constitute a binding contract under local law and be signed by both parties. If the binding commitment is made, the building does not have to be placed in service until the end of the specified later tax year (which cannot be later than 2009). Please note that a binding commitment is NOT considered an allocation for the current year and does not reduce the state commercial revitalization expenditure ceiling until the specified later tax year in which it is actually allocated. So you cannot reduce the 2002 state ceiling for a binding commitment made in 2002.

17) If an allocation is made for a project that is never put into service, can the RC reallocate unused incentives?

Answer: No provision in the Internal Revenue Code allows a reallocation of unused CRDs. Therefore, the allocation would be lost forever.

18) What should the CRA give to businesses that receive a CRD allocation? Is there a required form or letter from the CRA to substantiate the allocation?

Answer: No specific form is available or under development to inform the taxpayer of an allocation. A letter or other notice signed by an authorized CRA official reporting the date and dollar amount of the allocation, the address of the building, and the name and address of the owner of the building would be a valid allocation as of the date it is mailed to the building owner.

- 19) In a mixed-use project (<80% of gross rental income from dwelling units) that is CRD eligible, are all capital expenses eligible or only the expenses from construction or rehabilitation of the commercial component of the property?

Answer: the same rules that apply to exclusively commercial buildings also apply to "mixed-use" buildings (assuming less than 80% of the gross rent is from dwelling units). Both types of buildings are considered nonresidential real property and therefore no allocation is made between the residential portion and the commercial portion.

But please note that not all capital expenditures are eligible for the deduction --- the expenditures described in section 1400I(b)(2)(B) (relating to part of the acquisition cost of a rehabilitated building and expenditures used to compute any tax credit) cannot be included as qualified revitalization expenditures.

- 20) I am talking to a developer who is looking to build a new 7 million dollar hotel. Here is the question; 1/2 of the building will be in the renewal community census tract 303 with the remainder of the hotel in another township, not in the renewal community. Would this business qualify for the commercial revitalization credit or a pro-rata portion or not at all.

Answer: The statute does not address how to treat a building that is included in more than one census tract (for purposes of claiming the CRD). The taxpayer should request a private letter ruling rather than relying on informal advice. The first Internal Revenue Bulletin that IRS issues each year provides procedures on requesting private letter rulings.

More helpful information regarding the CRD:

The CRD allocation plan is the responsibility of the commercial revitalization agency (CRA) and it must be approved by the governmental unit of which the agency is a part. It does not need to be approved by the IRS. There is nothing in the statute that requires the CRA to track deductions. Regarding noncompliance, that issue is unique to the low-income housing credit. It is not a CRD issue. The CRD can only be claimed by the taxpayer who places the building in service and depreciates the building. The owner is the taxpayer who claims the depreciation, not the lessor. The plan can be as complicated or simple as the CRA decides it should be, as long as it takes into account the statutory requirements in IRC section 1400I(e)(2).